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Building China's Overseas Investment and Financing Cooperation

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Introduction

The 2008 global financial crisis reshaped the global economic and investment landscape. Outbound investment of developed economies decreased, and China's proportion steadily rose (United Nations Conference on Trade and Development [UNCTAD], 2016). In 2015, China ended the surplus in foreign direct investment (FDI) inflow that had lasted for more than 30 years, and its outward foreign direct investment (ODI) exceeded FDI inflow for two consecutive years (Ministry of Commerce [MOFCOM], National Bureau of Statistics [NBS] & State Administration of Foreign Exchange [SAFE], 2017).

According to statistics from the MOFCOM, NBS and SAFE, in 2016, China's utilisation of foreign capital reached CN¥813.2 billion (US$126 billion). The country's ODI flows amounted to CN¥1.1299 trillion

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(or US$170.1 billion), ranking second globally, only after the United States (US). China's Belt and Road Initiative, which has drawn global attention, is linked strongly to the previously launched 'go global' strategy and international cooperation on industrial capacity. Both of these strategies regard overseas investment as vital. The scale of China's overseas investment and construction projects is likely to expand further at a rapid pace. With continued promotion of the 'go global' policy, international industrial capacity cooperation and the Belt and Road Initiative, the room for growth is tremendous.

Enterprises cannot 'go global' without appropriate financial support, and the rapid development of overseas investment and project construction poses greater demands on China's overseas investment and financing system and corresponding cooperation.

Meanwhile, many host countries of China's overseas construction projects and investments are developing and emerging economies with tremendous capital demand. However, financial systems in some of these countries and regions remain underdeveloped and unable to provide adequate financing to meet investment needs. Given the huge demand for investment and financing in related projects, any single country is unable to provide sufficient funding purely from its own sources and China is no exception (Zhou, 2017). To meet such investment needs and ensure the sustainability of China's overseas interests, China should establish an investment and financing cooperation framework to facilitate enterprises' 'going global', encourage international industrial capacity cooperation and promote financial integration.

To address the aforementioned concerns, China should follow the basic principles of market-oriented operation and have enterprises play the primary role in overseas investment and financing. It should also clarify the roles of market, government and international institutions in the process. Although on an international scale there is no lack of capital in the private sector overall, enthusiasm remains relatively low for projects with long cycles, slow payback and uncertain profitability. This requires the government to play a guiding role and help eliminate institutional constraints and information asymmetry faced by the supplier and demander of funds. If necessary, the government should use public funds to leverage funds from the private sector and international institutions.

Specifically, the role of government and the market should vary in relation to different investment and financing projects. In general, three project categories exist. First, projects that can be operated entirely on a profit-oriented basis should be undertaken by the private sector. Second, in terms of projects that are profitable but face certain information asymmetries and defects in the regulatory environment, the government should facilitate private investment by improving the investment climate, instead of intervening directly. It should eradicate institutional obstacles and reduce information asymmetries. Third, with projects that are extremely capital intensive, highly susceptible to political situations and impossible for the private sector to take on alone, but that also possess some strategic benefits—such as those with high risk and slow payback elements and those in definite need of public and concessional funds—the government should play a leading role. It should deliver support through credit enhancement, guarantees and other services, and leverage capital fully from international development institutions, private sector and financial institutions at home and abroad. Regarding highly strategic and policy-based projects that are still operating in the red despite public backing, as they can no longer be viewed as commercial investments they will not be discussed in this chapter.

Additionally, the role played by public funds in investment and financing cooperation should vary in different host regions. When investing overseas in Europe, the US and other developed economies where the market is completely competitive and the legal, institutional, investment and financing systems relatively sound, Chinese-funded enterprises should be allowed to compete freely with their international counterparts and gain project funding from the market. Conversely, overseas projects in developing and emerging economies may find it difficult to use local funds. It is highly possible that investment and financing services formerly covered by the private sector are now in short supply, and government engagement is needed. Public funds can be used to attract and obtain the required capital.

Starting with the characteristics and problems of overseas investment and financing cooperation, this chapter studies how the government could facilitate investment and financing cooperation, especially for large-scale and long-term projects in underdeveloped regions that lack private sector support, while adhering to market-oriented operations.

Part 1: An assessment of China's overseas investment and financing cooperation

Chinese enterprises 'going global' and investing abroad are experiencing a period of fast development, with the level of investment flow and stock at record-high levels. Alongside this, problems have developed in relation to China's overseas investment and financing cooperation framework. Taking the Belt and Road Initiative as an example, most countries in the relevant regions are emerging and developing economies with a shortage of capital and an excess of historical burdens associated with infrastructure and interconnection projects. These countries rely heavily on external funding and are in urgent need of international support. They also have certain expectations about concessional rates of funding. Meanwhile, although China's overseas investment is expanding rapidly, it had a late start. The investment and financing framework still requires improvement. Investment and financing cooperation is also facing various challenges. This part briefly introduces the basic features of China's overseas investment and financing, evaluates the opportunities and risks of overseas investment and financing cooperation, and conducts an in-depth analysis of existing problems.

Basic features of Chinese enterprises' overseas investment

First, despite its late start, China's overseas investment is expanding rapidly, and the growth outlook is highly optimistic. China's ODI has soared in the past decade. The NBS estimates that the average annual growth rate of China's newly added non-financial ODI from 2000–2016 reached 33.9 per cent. The ODI stock of Chinese mainland reached US$1.0979 trillion, exceeding the trillion-USD mark for the first time in 2015. China's ODI grew to US$1.281 trillion in 2016, ranking China sixth globally after the US, Hong Kong, the United Kingdom (UK), Germany and Japan (see Table 7-1). The flow of China's ODI in 2016 (see Figure 7-1) stood at US$170.1 billion, second only to the US. Although China has the highest growth rate and largest stock of overseas investment among emerging economies, the gap between China and the major advanced economies remains large. At the end of 2016, China's ODI stock was equivalent to 11 per cent of its gross domestic product (GDP), significantly lower than the US's 34 per cent, Japan's 28 per cent, Germany's 39 per cent, France's 51 per cent and the UK's 55 per cent. When compared to other countries, China's potential for ODI growth is great. This is due to the advancement of China's reforms and opening, as well as continuous integration with its neighbouring countries.

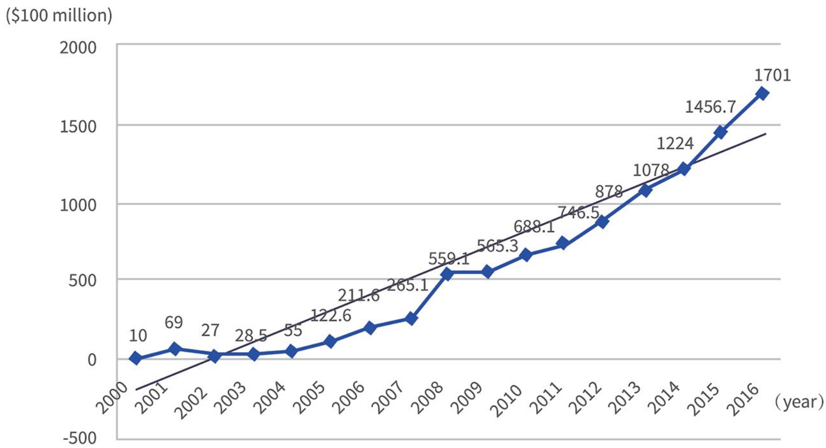

Figure 7-1: China's ODI flow since 2000 (US$100 million).
Source: MOFCOM, NBS & SAFE (2017).

Table 7-1: Comparison of ODI between China and major countries/regions

Countries/regions	ODI stock (US$100 million)		
	2000	2010	2016
US	26,940	48,096	63,838
Hong Kong China	3,793	9,439	15,279
UK	9,402	16,863	14,439
Japan	2,784	8,311	14,007
Germany	4,839	13,646	13,654
China	278	3,172	12,810
France	3,659	11,730	12,594
Netherlands	3,055	9,681	12,560
Canada	4,426	9,985	12,200
Switzerland	2,322	10,413	11,309
US	26,940	48,096	63,838

Source: UNCTAD (2017).

Second, the focus of investment and financing cooperation has gradually expanded from Asian economies to developed countries in Europe and the US. In the past decade, advanced economies have remained a major destination for global FDI, and they received 59 per cent of total global FDI in 2016 (UNCTAD, 2017). However, as international experience indicates, in the initial stage of overseas investment, a country prefers to invest in surrounding regions and in economies at a similar developmental stage. As a country's economy grows, the destination of its overseas investment gradually extends to developed economies. This experience reflects the trajectory of China's outbound investment. The stock of China's foreign investment in Asia reached US$768.9 billion at the end of 2015, 70 per cent of China's total foreign investment. Most of this flowed into developing economies. In the same period, only 10 per cent of China's total overseas investment went to Europe and the US. Notably, although the share of investment outflow to developed countries is still relatively small, it shows an upward trend. This is occurring because Chinese-funded enterprises are becoming increasingly competitive internationally and their appetite for advanced technologies and entry into the markets of developed countries continues to grow. Advanced economies in Europe and the US are gradually becoming popular destinations for Chinese investment and acquisitions. China's investment in Europe and the US accounted for 25 per cent of its total outbound investment flow in 2015. As the Boston Consulting Group (2015) highlighted in its report on China's overseas mergers and acquisitions (M&As) over the past decade, the focus and target of China's overseas M&As has shifted and is increasingly aimed at acquiring technology, brands and market share.

Third, a noticeable shift has occurred in the distribution of target industries. Mining has traditionally been a major recipient of China's overseas investment, accounting for 48.4 per cent of the total outflow in 2003. However, Chinese outbound investment has been gradually diversifying as Chinese enterprises accelerated their pace of 'going global' and participation in international industrial capacity cooperation. Some countries reduced FDI restrictions to attract foreign capital after the 2008 global financial crisis. Sectors such as business services, financial services and manufacturing have also witnessed substantial growth. In terms of ODI flows, the three industries that received the highest proportion of China's ODI in 2015 were leasing and business services, financial companies and manufacturing companies, accounting for 24.9 per cent, 16.6 per cent and 13.7 per cent respectively. ODI in the manufacturing sector has grown rapidly, while ODI in the mining sector has dropped out of the top three. In terms of ODI stock, the leasing and business sector came first with US$409.57 billion at the end of 2015, 37.3 per cent of the total stock. This was followed by the financial sector with US$159.66 billion, 14.5 per cent of the total stock. The mining sector came third with US$142.38 billion, or 13 per cent of the total stock (see Figure 7-2). These statistics reveal that China's overseas investment is experiencing an obvious structural transformation. Apart from traditional industries, such as infrastructure and energy and resources, business services, financial services and manufacturing sectors are all developing fast. Increasing diversification in target industries is evident.

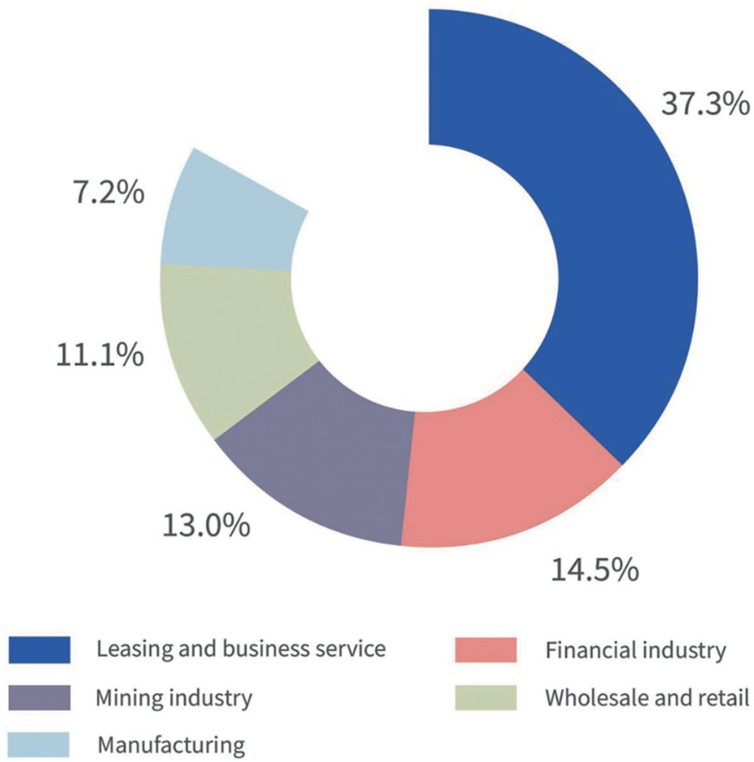

Figure 7-2: Distribution of China's overseas investment stock by industry in 2015.

Source: MOFCOM, NBS & SAFE (2017).

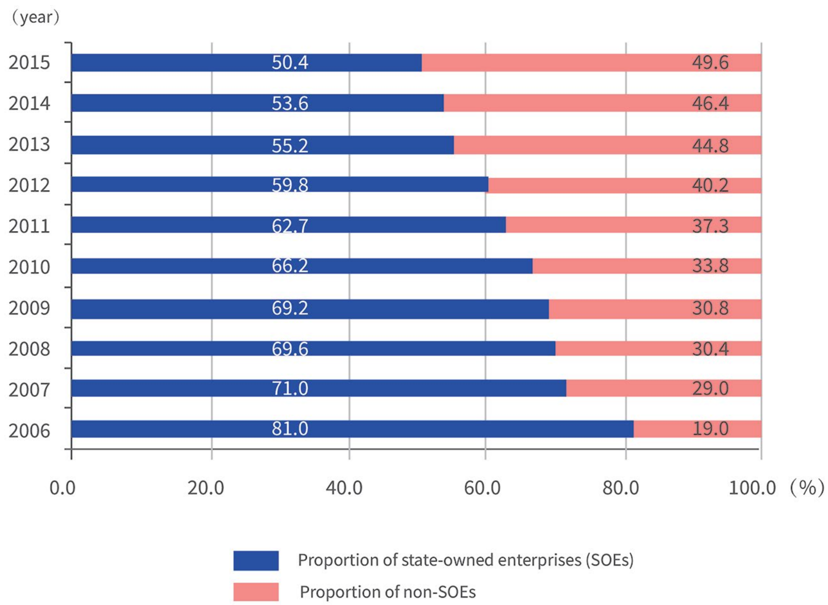

Figure 7-3: Distribution of China's overseas investment stock by ownership in 2015.

Source: MOFCOM, NBS & SAFE (2017).

Fourth, non-state-owned enterprises (non-SOEs) have become the dominant driving force for China's outward foreign investment. At the end of 2006, the share of ODI stock by state-owned enterprises (SOEs) was 81 per cent, whereas that held by non-SOEs (including limited liability companies, companies limited by shares, and private enterprises) was 19 per cent (see Figure 7-3).

At the end of 2015, the share of SOE investment in ODI stock dropped to 50.4 per cent, whereas that of non-SOE investment increased to 49.6 per cent. In terms of flow and the number of investment entities, non-SOEs (especially companies with limited liabilities) have already become the main driving force in China's ODI. Clearly, China's overseas investment is becoming diversified and multi-layered.

China's foreign investment is characterised by its long cycle, large scale and high risks, and opportunities and challenges coexist in investment and financing cooperation

In general, many Chinese ODI projects have long cycles, are large scale and face relatively high risks. First, in terms of regional distribution, although China's investment in developed countries has grown rapidly in recent years, developing countries in the vicinity have still absorbed most of China's ODI. In fact, 80 per cent of China's ODI stock goes to projects in developing economies, including many major cooperation projects along the Belt and Road regions (MOFCOM, NBS & SAFE 2017). In most of these countries and regions, financial markets are still underdeveloped and the level of marketisation requires further improvement.

Second, in terms of industry distribution, although business and financial services take up a relatively large share of China's ODI, infrastructure construction, energy and resources, and equipment manufacturing are still important target sectors (Wang & Li, 2017). Investments in these areas are typically large, long term and have slow payback. Such projects have relatively high demands for long-term equity funds. However, the financial market can only offer a limited amount of medium- and long-term equity funding.

Third, in terms of industry sensitivity, energy and resources, one of the major target sectors of China's outbound investment, is highly sensitive and protected. Host countries increasingly prefer to reserve the benefits of exploitation and subsequent increments to local firms and, therefore, impose strict regulatory and supervisory requirements on the entry, shareholding ratio, export and taxes of foreign investors (Li, 2015).

The aforementioned characteristics of China's overseas investment not only pose challenges, but also create opportunities for China to conduct investment and financing cooperation with other countries. Enterprises that 'go global' often face many difficulties and constraints in overseas financing. For example, many Chinese enterprises lack sufficient credit records in host countries, making it difficult for them to obtain funds from local financial institutions. Additionally, the credit records of newly established subsidiaries of Chinese enterprises are often relatively brief and, thus, they cannot access funds at low costs. Meanwhile, it takes time for enterprises to adapt to overseas financing procedures and legal environments.

Conversely, as developing and emerging economies are the major destinations for China's overseas investment, where capital shortage is a common issue, private sector investment and financing services are often absent. Chinese-funded enterprises can also face bottlenecks and constraints when seeking funds through domestic financial institutions or their overseas branches. For example, these branches are distributed mostly in developed economies instead of emerging or developing countries where most Chinese outward investment is destined. Taking the Bank of China (BOC) and Industrial and Commercial Bank of China (ICBC) as examples, these two Chinese banks have the largest overseas branch networks, but cover only 40 countries or regions, overlapping minimally with the distribution of China's overseas investment. Conventional commercial financial institutions can only provide short-term loans, which are typically due in less than five years. They seldom offer medium- and long-term financing. Domestic banks in general do not accept foreign property as collateral. They tend to 'favour the rich and disdain the poor' and are more likely to refuse lending requests from non-SOEs for overseas investment projects out of risk management considerations.

In terms of opportunities, transnational corporations from advanced economies have already begun to seek market opportunities and resources across the globe, occupying relatively mature markets and sectors. Because of the aforementioned features of China's target regions and industries, Chinese-funded enterprises have the opportunity to break into regions and industries where developed countries have traditionally found entry difficult. As such, with good planning and a reasonable cooperative framework for overseas investment and financing, China has a real chance to achieve 'corner overtaking' in its ODI.

In practice, rather than performing well, some Chinese-funded enterprises have suffered setbacks and frustrations in the overseas investment process. For example, of the 106 Chinese-funded companies that hold shares abroad, only three made a profit at the end of 2014 (Wang, 2015). The China Mining Association notes that 80 per cent of Chinese enterprises incurred losses for overseas mine purchases (China Mining Association, 2014). Additionally, statistics from the All-China Federation of Industry and Commerce show that 67 per cent of private enterprises venturing abroad experienced disappointments and only 10 per cent made a profit. Such poor performances can be partially attributed to risk factors such as political, legal and cultural differences, along with management, project selection and economic cycle issues. However, in some cases, the failure of an enterprise is linked directly to unreasonable and inflexible financing arrangements. For example, some Chinese-funded enterprises use cash instead of stock as consideration in overseas M&A transactions, and a lot of capital is raised through external debts. Additionally, the underdeveloped direct financing systems in China and the dominant role of bank credit in financing such investments have each partially contributed to this phenomenon. More notably, there is a tendency among Chinese enterprises to overpay because most of their transnational M&A deals are pro-cyclical and conducted across industries. The long running-in period after M&As and comparatively high debt leverage could also lead to potential risks. To address the problems and risks faced by enterprises, the government should provide guidance and develop innovative institutional arrangements. The ultimate goal is to improve the sustainability of overseas investment and create a favourable financial environment for Chinese enterprises to 'go global' and engage in international industrial capacity cooperation.

The capital demand of developing and emerging economies for construction projects is massive and can hardly be satisfied by China alone, thus, a sound investment and financing cooperation framework is needed.

Developing and emerging economies are the primary host countries of China's overseas projects and investment. Their demand for capital for economic and social development is tremendous. The Asian Development Bank (ADB) estimates that the demand for infrastructure investment in Asia will amount to US$26 trillion between now and 2030, equivalent to US$2.5 trillion per year. According to the Hong Kong Monetary Authority, the annual capital requirement for construction-related infrastructure along the Belt and Road regions is between US$0.8 and US$1 trillion. In a report published in 1994, the World Bank proposed a policy objective that set the share of infrastructure investment at no less than 5 per cent of GDP (Yuan, 2016). Based on this target, the authors have conducted a simple linear prediction of the annual investment demand for infrastructure construction in major Belt and Road regions (see Table 7-2).

Table 7-2: Forecast of the infrastructure investment demand along the Belt and Road regions (US$100 million)

Share	Countries/regions	2017	2018	2019	2020	2021	Total	Annual average
Low (3%)	Emerging economies and developing countries in Asia	5,125	5,569	6,053	6,593	7,177	30,519	6,104
	Commonwealth of Independent States	619	646	671	702	737	3,376	675
	Middle East and North Africa	979	1,039	1,101	1,173	1,254	5,546	1,109
	Total	6,724	7,255	7,826	8,468	9,168	39,441	7,888
Medium (5%)	Emerging economies and developing countries in Asia	8,542	9,282	10,089	10,989	11,961	50,864	10,173
	Commonwealth of Independent States	1,032	1,077	1,119	1,170	1,228	5,626	1,125
	Middle East and North Africa	1,632	1,731	1,836	1,954	2,090	9,244	1,849
	Total	11,207	12,091	13,044	14,114	15,279	65,735	13,147
High (6%)	Emerging economies and developing countries in Asia	10,251	11,139	12,107	13,187	14,354	61,037	12,207
	Commonwealth of Independent States	1,239	1,292	1,343	1,405	1,474	6,752	1,350
	Middle East and North Africa	1,958	2,078	2,203	2,345	2,508	11,092	2,218
	Total	13,448	14,509	15,652	16,937	18,335	78,882	15,776

Source: Authors' original calculation based on statistics from the IMF's World Economic Outlook database.

We divide the infrastructure investment to GDP ratios into three categories—low, medium and high—and set their values at 3 per cent, 5 per cent and 6 per cent respectively. The size of investment demand is then obtained by multiplying the GDP forecasted by the International Monetary Fund (IMF) by the infrastructure investment to GDP ratio. As shown in Table 7-2, the annual demand for infrastructure investment in Belt and Road regions is likely to reach US$0.8 to US$1.6 trillion between 2017 and 2021.

In sharp contrast, according to MOFCOM data, China's total 2016 investment in the Belt and Road regions was US$14.53 billion, lagging far behind the demand for investment and financing indicated above. Most of China's investment goes to developing and emerging economies, where the financial systems are underdeveloped and neither public nor private financing can satisfy local capital needs. Conversely, as the world's second-largest economy, second-largest foreign investor and largest holder of foreign exchange reserve, China is widely considered to hold large amounts of capital. Concessional funds from China are also expected. Therefore, to conduct overseas investment and financing cooperation more effectively, including infrastructure construction projects along the Belt and Road regions, and to meet the huge demand for investment and capital, China must fully mobilise resources from all stakeholders. This will not only promote economic growth in host countries, but will also facilitate the 'going global' of Chinese enterprises, equipment and technologies. In doing this, Chinese investors can also achieve better returns.

Nevertheless, it is important to note that developing funding platforms and facilitating financial integration to help enterprises 'go global' and attain international industrial capacity cooperation does not mean one-way financial support or unilateral interest concessions (Zhou, 2017). In a reasonable investment and financing cooperation framework, funds must be operated in accordance with market and commercial principles, with risks and losses borne by the institutions themselves. Behaviour must also reflect self-discipline; that is, all parties' resources must be fully mobilised, with each party both undertaking responsibilities and enjoying the benefits. In this way, a positive incentive mechanism can be formed and sustainable development secured. Additionally, due to limited government resources, overseas investment and financing cooperation cannot rely mainly on public funds. Instead, it needs to reinforce the division of responsibilities and cooperation between the government and market, only using public funds to free up and leverage other funds. China should follow the leading principles of market-oriented operation and primary role of enterprises to secure sustainable investment and financing.

Existing problems in China's overseas investment and financing cooperation

With the continuous integration of China into the world's economy, the potential for China's overseas investment and financing is enormous. However, in the process of 'going global', Chinese-funded enterprises face increasing conflicts and problems. Some of the most pressing challenges confronting Chinese financial institutions and enterprises are detailed below.

First, disorderly competition occurs when some financial institutions compete for projects. For example, many financial institutions have reported that it is common for domestic financial institutions to rush to fund the same high-quality overseas projects. Overheated competition and a lack of proper incentive mechanisms then cause lending conditions to be excessively relaxed. Chinese-funded financial institutions should base their overseas funding and expansion decisions on specific project requirements and their own specialties. To address hasty expansion and disorderly competition, financial regulatory authorities should provide a favourable environment, improve market access conditions and tighten the supervision of overseas operations. It is necessary to strengthen top-level design and create a mechanism for the unified coordination of major projects. The goal is to integrate the respective advantages of, and create solidarity among, Chinese enterprises and financial institutions for overseas investment.

Second, some enterprises have overlooked the risks and invested blindly. Poor understanding of local environments and social norms may lead to environmental pollution and violations of religious, labour and cultural customs, damaging the business and reputation of the financial institutions and corporations involved in an investment. For example, according to media reports, the State Power Investment Corporation initiated the Myitsone Dam project in December 2009 with the Myanmar Government's permission. However, in September 2011, the Myanmar Government halted the project, citing public concerns as the main reason. Many thought this project could destroy Myitsone's natural scenery and local culture, affect the harvest of local rubber plantations and crops, and lead to various climate and environmental problems. Although the Myanmar Government later established an inquiry committee to determine an appropriate solution, the project remains suspended at the time of writing and Chinese investment of more than US$2 billion is facing grave uncertainty. As it is uncertain when the project may resume, any possible return on investment appears distant (Bao & Li, 2015).

Third, monitoring and accountability mechanisms for public and concessional funds are inadequate. Only when capital provider values return will they focus on the effectiveness of capital utilisation instead of investing blindly and wilfully (Yin, 2017). Taking the light rail project in Mecca, Saudi Arabia, as an example, the Chinese listed company China Railway Construction Corporation (CRCC) won the bidding for this project in 2009. At that time, a Saudi Arabian corporation more familiar with the local engineering specifications submitted a quotation of US$2.7 billion, compared to the quotation of US$1.7 billion by CRCC. Although the project was delivered on time, was high quality and was well received after operation began, CRCC's misjudgement of the project's costs, along with mistakes made during the project management process and contract alterations, caused a total deficit of 4.15 billion RMB by the time of completion in 2010. To reduce shareholder losses, CRCC (the parent corporation) covered the shortfall. Although the Mecca light railway project won a good reputation for Chinese railway projects abroad and created favourable social effects, financially it brought about an unexpected and massive loss. Throughout the process, risk management and accountability mechanisms had clearly failed to fulfil their intended role (Bao & Li, 2015).

Fourth, enterprises also encounter some bottlenecks and constraints when they seek financing from domestic financial institutions or their overseas branches. To begin with, Chinese financial institutions have yet to extend their operations to cover a large number of developing and emerging economies. In terms of coverage, Chinese enterprises have already spread across 180 countries or regions. However, the overseas branches of Chinese commercial banks cover only 60 or so countries or regions and are concentrated in advanced economies. They are yet to form a global network and, as such, are unable to fully support Chinese enterprises' overseas financing needs. Regarding investment banks, their coverage is even smaller, and their overseas branches are similarly clustered in advanced economies. Overseas branches serve important purposes as they allow financial institutions to play a frontline role. Therefore, whether better coverage can be achieved will significantly influence the ability of Chinese financial institutions to support the enterprises' overseas investments.

Moreover, the capability and services of existing overseas branches of Chinese financial institutions must improve. In recent years, as the 'going global' efforts of Chinese enterprises have taken increasingly various forms, needs have developed for more diverse financial services. Besides traditional services, such as financing, payment and settlement, and bank guarantees, there is growing demand for M&As, equity investment, derivatives transaction, investment consulting and other investment bank services and insurance-related financial services. Although Chinese financial institutions have gained remarkable expertise in recent years, they are still relatively inexperienced in international operations compared with their long-established international counterparts. They have yet to develop the ability to navigate the international financial market and integrate domestic and foreign financial resources with ease. For example, with limited capital reserve, financial institutions' overseas branches enjoy little advantage in terms of financing size and interest rates. They are also less knowledgeable about the compliance risks in host countries than local financial institutions. Their ability and efficiency in helping enterprises circumvent supervision and avoid legal risks remains underdeveloped. Gaps also exist with foreign financial institutions in terms of providing innovative and comprehensive products and services. Increasing the competitiveness of overseas branches of Chinese financial institutions is an urgent task.

Fifth, the scale of Chinese enterprises' cross-border M&As is expanding rapidly, and a high proportion of these are backed by debt financing. ODI is divided into cross-border M&As and green field investment. The former has grown rapidly in recent years. In 2016, Chinese enterprises conducted 742 cross-border M&As with a total transaction value of US$107.2 billion, achieving a year-on-year growth of 167 per cent. With such explosive growth, debt financing has also become common, leading to an increase in corporate leverage and a subsequent rise in overseas operational risks. Statistics jointly released by the MOFCOM, NBS and SAFE show that, on average, 28.9 per cent of China's ODI capital from 2009 onwards came from loans and other types of debt financing from domestic banks (see Table 7-3). Given that some projects may secure debt financing overseas, and that the newly added capital stock of subsidiary corporations is likely secured partially through parent corporations' debt financing in China, the de facto share of debt financing may be even higher.

Table 7-3: Financing method of China's ODI (2009–2015)

Year	Newly added capital stock (%)	Reinvestment of current profit (%)	Loans, etc. from domestic banks (%)
2009	30.5	28.5	41.0
2010	30.0	34.9	35.1
2011	42.0	32.8	25.2
2012	35.5	25.6	38.9
2013	28.5	35.5	36.0
2014	45.3	36.1	18.6
2015	66.4	26	7.6
Average	39.7	31.3	28.9

Source: MOFCOM, NBS & SAFE (2016).

Additionally, according to statistics from Thomson Reuters, in international M&As the median debt to EBITDA ratio[6] is around 3.0 globally, whereas that of Chinese enterprises involved in overseas M&As in 2015 was 5.4. This is a telltale sign of high leverage. This can be partially explained by the dominant position of banks in China's financial system and the high threshold of equity financing. It is also closely related to the fact that China's financial system remains underdeveloped.

China's overseas investment is placed mainly in developing and emerging economies. These investments are characterised by long cycles, large scales and high risks. Government bodies and official funds should make targeted efforts to facilitate overseas investment. It is necessary to refine the cooperative framework of overseas investment and financing; leverage capital from various parties with governmental funds; and address the financing difficulties and financial risks instigated by the mismatch of risk, return and duration of projects. The Chinese Government should also provide a favourable macroeconomic and financial environment for Chinese enterprises to participate in international economic competition and collaboration and should actively integrate itself into global production and value chains. Moreover, the flow of capital should be

6 Debt to EBITDA ratio reflects the corporation's ability to sustain and support its debts with profits. The smaller the value, the greater the solvency of the corporation.

directed into overseas investment projects that are important for China's industrial upgrading and strategic positioning within the international production chain. Additionally, China should uphold a market-oriented approach and maintain the dominant role of enterprises, improve risk management and accountability mechanisms for concessional funds, optimise the financing structure of enterprises' overseas investment, and support qualified domestic enterprises to conduct authentic and legitimate investment abroad. This will ensure the sustainability of investment and financing.

Part 2: Guidelines for conducting overseas investment and financing cooperation

The key to overseas investment and financing cooperation is diversification of interests and decentralisation of risks. From a long-term perspective, one-way fund support from China to developing and emerging economies is hard to sustain. An effective mechanism must be established for all parties to share costs, risks and returns. This mechanism should use market force to mobilise all available resources, ensure the sustainability of funds and maximise the interests of overseas investment. Based on the aforementioned considerations, we argue that China should uphold the following principles in overseas investment and financing cooperation.

Mobilise various parties to participate in overseas investment and financing cooperation

As mentioned previously, it is impossible for a single country to meet the capital need for overseas projects and international industrial capacity cooperation. Therefore, collaboration is essential. China should engage a broad range of stakeholders and mobilise various resources to use global capital effectively, alleviate China's financing strains and diversifying investment risks.

Engaging more stakeholders helps mobilise capital from more sources. A number of overseas cooperation projects in which China has participated featured long construction periods and slow returns. Without the timely commitment of funds, project implementation may be delayed and economic benefits reduced. This may also cause negative political influence. Therefore, investment and financing should be sustainable, which requires collaboration between all parties and sharing of costs and interests. To this end, the government and market should work together to mobilise the resources of stakeholder countries to provide multi-channel, medium- to long-term, sustainable funding for projects and reduce the burden on China.

Engaging more stakeholders also helps with risk prevention. Capital users will only seriously consider how to place funds where they are needed most when they bear the cost of the capital (Yin, 2017). Therefore, introducing capital from host countries helps to reduce project risks. Apart from collaborating with host countries, China could also foster common interests with some competitors to promote the sustainability of overseas projects. For example, the Myanmar Government suspended the Myitsone Dam project (in which China invested) out of environmental concerns, but the China–Myanmar Oil Pipeline project was not affected because of the joint participation of Myanmar, South Korea, India and other countries. This pipeline started pumping successfully in June 2017 (China Economic Net, 2017). As such, China should establish a framework of overseas investment and financing, and encourage countries with the capital, experience or demand for projects to collaborate. In this situation, each party can exert its strength based on the principle of mutual benefits, to share both risks and benefits.

Building on international experience, China should adhere to the following principles. First, for major projects, Chinese enterprises may cooperate with entities from other countries, including financial institutions in advanced economies, to share costs, risks and profits. It could also relieve concerns and increase international pressure on borrowers in relation to debt default. Major projects generally require significant amounts of funds, meaning they cannot be bankrolled by a single financial institution. Instead, these projects could be raised through international syndicated loans, with the participation of financial institutions in developed economies. In this way, the integration of funds and distribution of risks can be achieved, and long-term, large-scale, stable funding support and matching financial services for major projects secured. China can also simultaneously learn from the experiences of financial institutions in advanced countries.

Moreover, China may enhance cooperation with commercial banks in host countries to share benefits and risks. By encouraging the contribution of capital stock from local investors, financial institutions and investors in host countries will attach more importance to the operation and profitability of projects, thus ensuring the safety of Chinese investment.

Finally, multilateral development institutions—which have been working extensively in host countries for many years—often bring obvious advantages and are more experienced with risk control. Thus, cooperation with multilateral development institutions in investment and financing should be reinforced. This may include establishing joint investment funds and conducting co-investment business.

Optimise industry layout and conduct overseas investment and financing based on regional comparative advantages

In recent years, Chinese enterprises have sped up their 'going global' efforts. They have established various industrial parks abroad, transferred production capacities where needed and expanded their overseas markets. As each region is unique, with its own distinctive comparative advantages, China should pay attention to the choice of industry and location for overseas investments to optimise the spread of China's industries.

Since the reform and opening, China has successfully developed labour-intensive industries by making use of its comparative advantage of cheap labour. This has made a significant contribution to China's economic growth and employment. Nonetheless, after decades of rapid development, the situation has changed. In terms of demographic structure, China's working-age population has begun to shrink. In terms of wage levels, China's annual per capita GDP has increased from US$300 in the early stages of reform and opening to the current level of US$8,000. GDP per capita in coastal regions, where export industries are concentrated, has approached or reached the level of high-income economies. There has been a clear increase in labour costs. These data suggest that China's comparative advantage of cheap labour, which once propped up its labour-intensive industries, is disappearing. Conversely, after years of investment China's capital stock has increased substantially, with progress in education and research. Technology and labour quality have also advanced remarkably.

Compared with the early stages of reform and opening, or when China joined the World Trade Organization (WTO), there has been substantial change in the quantity and price of labour, capital and technology in China. The shift in comparative advantage and industrial upgrading is not only a natural outcome of China's economic development, but is also necessary for sustaining relatively high growth. With this change, some industries could move overseas to countries and regions with complementary conditions to China. Against this backdrop, to maximise returns on overseas investment, Chinese enterprises should pursue a differentiation strategy and choose target industries and locations based on local characteristics and complementary comparative advantages.

Clarify the positions of the market and government in overseas investment and financing cooperation

In the process of overseas investment and financing cooperation, the market should play a decisive role in resource allocation. Only through allocating capital under market-oriented and commercial principles will investors and projects be self-disciplined, take responsibility for risks and losses, and pursue a balance between benefit and risk. In this way, the efficiency of financial resource allocation will be improved and sustainable development realised. Additionally, given the huge scale of the capital required by China for outward investment, it is essential that the market should play a decisive role in capital allocation. It should provide well-tailored financial services on a case-by-case basis to improve the effective integration of resources.

As previously mentioned, some host countries require much improvement in terms of marketisation and financial systems. From an industry perspective, infrastructure, energy and resources, and equipment manufacturing industries all have long investment cycles and slow payback schedules. As a result, market failures sometimes occur. For example, a lack of investment and financing services in the private sector may hinder some public welfare projects that have slow cost-recovery periods, long investment cycles and great risks. Despite the positive externalities of such projects, they are hindered by uncertain profit outcomes or the long period required to reach profitability. Therefore, the government should play a supportive role and also be a sweeper—using public funds to leverage other types of funds, reducing or eliminating obstacles that impede private funds, and promoting the incubation and launching of projects.

However, special attention should be paid to efficiency when public funds play a supplementary role. It is only when the fund provider pays due attention to benefits, instead of providing financial resources wilfully, that such funds can be invested where they are most needed. If funds are used inefficiently, problems such as moral hazards in the host country and an over-reliance on preferential funds may arise. This will not boost the economic growth of developing countries and may restrain their development and hinder further cooperation (Zhou, 2017). Therefore, before using government resources for investment and financing, the following issues should be considered. First, is it possible for the project to be fully financed by the private sector through the market or commercial means? Second, if no private sector companies are willing or able to provide financing due to problems such as high levels of risk or market failure, is it possible for the government to introduce corresponding policies or conduct-related reforms to reduce investment risks and improve the market environment, thereby providing a more welcoming environment in which the private sector can participate? Third, if government funds must be used, this should primarily be to reduce risks and should leverage resources from all possible parties, including funds from the private sector.

Given the limited government resources, it is not appropriate to rely mainly on them for overseas investment and financing cooperation. Instead, it is necessary to strengthen the division of responsibilities and cooperation between the government and market. The market should play a decisive role in resource allocation, and official funds can be used to leverage resources from other sources if necessary. Meanwhile, adherence to the principles of market-oriented operation and having enterprises play the primary role will ensure the sustainability of investment and financing. Additionally, strategic projects should also be differentiated from commercial projects. In terms of strategic projects (that are necessary and possess significant positive externalities), emphasis should be placed on quality over quantity so that public funds are most effectively allocated and used.

With a well-designed mechanism in place, some medium- and long-term strategic projects will also gain economic benefits. First, it is necessary to identify project users effectively and impose reasonable charges to generate economic returns. Second, due to factors such as large scale, long cycles and various uncertainties, some projects may have unapparent or minimal economic benefits in their early stages. In these circumstances, it is advisable to reduce uncertainties in project investment, construction and operation through reasonable mechanism designs, appropriate risk diversification and well-tailored financial tools to improve the economic returns.

Utilise overseas investment and financing cooperation to facilitate RMB internationalisation

Currently, many enterprises that have 'gone global' reflect that most of their foreign investments are financed in USD or RMB. Meanwhile, proceeds are received in the local currency. Due to unstable political and economic conditions and imperfect foreign exchange mechanisms, local currencies can fluctuate violently, leading to high exchange risks. Many projects have comparatively long construction periods, sometimes even spanning one or two decades. Yet, in general, the longest term of hedging tools for managing exchange rate risk is five years. Moreover, a majority of the Belt and Road countries have underdeveloped financial markets. Risk hedging tools in these countries are severely inadequate, making it difficult for Chinese corporations to hedge exchange rate risks.

In 2016, the RMB was officially added to the IMF's basket of currencies that make up the special drawing right, thus gaining status as an internationally recognised reserve currency. Increasing the RMB's use in the investment and financing of overseas Chinese projects can not only mitigate currency exchange risks, but also promote RMB internationalisation. Promoting international use of a domestic currency through investment and financing cooperation is not a new concept. From 1986–1991, Japan launched a US$65-billion capital recycling program in three phases (Liu, 2012). The goal was to alleviate international pressure on the current account surplus and, in the meantime, promote internationalisation of the JPY. To a certain extent, this program was successful (see Box 7-1).

Box 7-1: Japan's capital recycling program

Since 1980, the sharp increase in Japan's current account surplus has placed it under substantial international pressure. At that time, Japan could not promote the outflow of the JPY through trade. To promote internationalisation of the JPY, ease trade friction and take advantage of the financing needs of developing countries in Asia, Latin America and other regions, Japan designed a program to return part of the surplus to developing countries. It did this by providing them with official development assistance (ODA) and commercial loans. As surplus is recorded on international balance sheets in black, this program was dubbed the 'capital recycling program'.

The capital recycling program was conducted from 1986–1991 in three phases, covering a total of US$65 billion. The first phase was initiated in September 1986, focusing on contributing capital to the IMF and establishing the Japan Special Fund in the World Bank and the ADB. The total amount introduced in this phase was US$10 billion. This was mainly used to encourage international development agencies to issue JPY-denominated bonds in Japan, promote the participation of Japanese banks in syndicated loans of international development agencies and provide developing countries with JPY loans as a form of bilateral aid. The second phase began in May 1987, with a total commitment of US$20 billion. The third phase was launched in July 1989, with the total contribution in this phase reaching US$35 billion. The goal was mainly to support the US in implementing the Brady Plan and help manage the Latin American debt crisis.

Funding for the program came mainly from ODA budgetary fund and private capital, with latter accounting for 71 per cent of the funding (i.e. US$46 billion). Loans provided through the capital recycling program include project and non-project loans. Project loans targeted firms in the infrastructure, energy and raw material export sectors in developing countries in the Asia-Pacific region. These loans had relatively high concessional rates, longer repayment terms and fewer auxiliary conditions. Non-project loans were granted through the IMF and other international financial institutions, primarily to assist borrowing countries improve their international payment position and adjust domestic industrial structure.

Japan achieved substantial financial, political and diplomatic gains through the capital recycling program. It not only reduced trade friction and improved foreign relations, but also accelerated internationalisation of the JPY, supported the globalisation of Japanese firms and financial institutions, and increased Japan's international influence.

At present, many developing countries are in great need of funds, and urgently need to develop their domestic manufacturing industry and infrastructure. Therefore, a huge demand exists for full sets of equipment, project construction and other products and services from China. Additionally, overseas projects constructed by Chinese companies will also increase the demand for equipment from China. These demands have laid a solid foundation for the RMB's use in overseas investment and financing cooperation. Foreign parties can use the RMB earned through China's ODI to import Chinese goods and services. In this way, RMB flow back will be facilitated. RMB investment in suitable industries can further release the growth potential of other developing countries, while promoting the purchase of Chinese goods and services, export of Chinese equipment and RMB internationalisation. Additionally, investing and financing in RMB could reduce dependence on the USD and other currencies, boost confidence in and increase the attractiveness of the RMB, promote the development of offshore RMB markets, reduce the risks created by exchange rate fluctuations, and maintain stability in the foreign exchange rate and financial market. An important future direction for China to pursue is to use the RMB more frequently in overseas investment and financing cooperation. China should always uphold a market-oriented approach and the dominant role of enterprises in this process.

To date, China has made several attempts to explore RMB use for overseas investing and financing. First, at the Belt and Road Forum for International Cooperation held in May 2017, China announced that it would inject another CN¥100 billion into the Silk Road Fund. China also encouraged financial institutions to conduct overseas RMB fund business, which is estimated to total CN¥300 billion. Second, China has founded a number of RMB investment and loan funds, such as Sailing Capital International, to provide commercial investment plans and financial support to Chinese enterprises in their overseas investment and M&A activities. The total scale of Sailing Capital International has reached CN¥50 billion, of which CN¥12 billion came from the first round of fund raising. The fund also mobilised capital from other sources through various methods such as fund of fund, combination of investment and loans, and issuance of bonds. Third, development and policy-based financial institutions, such as China Development Bank (CDB) and Export-Import Bank of China (EIBC), have already issued many cross-border loans in RMB. For instance, loans granted by EIBC in RMB account for more than 60 per cent of its total overseas loans. Moreover, the proportion of overseas financing in RMB undertaken by EIBC has increased continuously. Fourth, commercial financial institutions have also begun to make loans in RMB in accordance with market-oriented approaches.

Part 3: Seize current strategic opportunities and build China's framework for overseas investment and financing cooperation

The Belt and Road Initiative and international cooperation of industrial production capacity have initiated ample strategic opportunities for creating a framework for China's overseas investment and financing. With the guidelines proposed above, we argue that China should encourage innovation in the design of investment and financing mechanisms; reduce uncertainty in overseas investment; and improve economic benefits through introducing sound financing arrangements, risk-sharing mechanisms and appropriate financial instruments. More specifically, China should use development finance effectively, refine policy-based financial tools such as export credit and promote the formation of an overseas financial operation network. It should also fully mobilise government and market funds, financial resources from host countries and the international capital market, and capital from multilateral development institutions. China should also make better use of equity funds and develop a market-oriented, sustainable framework of overseas investment and financing.

Promote development finance

According to international practices, enterprises that 'go global' mainly receive three types of financial support. The difference between them lies in the different value orientation towards market profits and national strategies. Commercial finance pursues profits following market principles. Policy-based finance serves national interests instead of market profits. Development finance, while aspiring to fulfil national strategies, also seeks to achieve breakeven or narrow profits to ensure sustainability (Zhou, 2015). There is a corresponding cost gradient, with commercial finance incurring the highest cost of capital and policy-based finance the lowest.

Of the three types, policy-based finance may face problems of low capital efficiency and increased fiscal burden. Additionally, its effect is relatively limited while there is a vast demand for capital by overseas investment and financing. Commercial capital performs well in terms of providing medium- and short-term financial support. However, it does not offer much long-term financing. The effectiveness of market-driven resource allocation in this field is less than ideal. Meanwhile, the actions of commercial financial institutions are typically pro-cyclical and 'favour the rich and disdain the poor'.

In such circumstances, development finance has its own advantage. It can fill the gap between policy-based finance and commercial finance. Development finance is an extension of traditional policy-based finance. It serves national strategies and relies on the credit worthiness of projects, rather than government subsidies. Run autonomously, it operates under market principles, emphasises long-term commitment and seeks financial sustainability with zero or modest profits. It is a financial model between policy-based finance and commercial finance, but leans towards the commercial side (Zhou, 2017). Currently, China's overseas investment and financing programs, including those along the Belt and Road Initiative, are characterised by slow payback timelines and a large capital requirement. In these cases, development finance could make significant contributions by exerting its strength in market-oriented operations, financial sustainability and medium- to long-term commitment. Indeed, existing practices have shown that development finance is advantageous in many aspects. With the support of government credits, it can secure long-term, stable funds at a relatively low cost through the issuance of policy-based financial bonds. Accordingly, it can provide long-term financial support for programs of its choice. Thus, the needs of medium- and short-term overseas investment can be met through commercial finance (market capital). However, commercial finance may avoid long-term programs with a slow return on investment (even if they are profitable) or if the cost of capital is too high to accept. This opens investment and financing services for the involvement of development finance.

Over the last few years, as long-term public resources have fallen short, the world's major development institutions are in the process of transforming their business models and increasingly emphasise the commercial feasibility and financial sustainability of projects. They are also seeking to leverage investment from the private sector through capital raised at a low cost from the international bond market, fully mobilise resources and support the economic development of all concerned countries. China has already been leading the world in this field, with the CDB and EIBC playing vital roles in enterprises 'going global'. The CDB is the largest investment and financing cooperation bank in China and the largest development financial institution in the world. Taking advantage of its medium- to long-term investment and financing capability, the CDB had extended over US$160 billion worth of loans to countries in the Belt and Road regions by the end of 2016, with an outstanding investment balance of US$110 billion. It has over 500 projects in its investment portfolio. Most projects are concentrated in the areas of infrastructure, energy and resources, and industrial production capacity cooperation, all of which require long-term financing. Apart from supporting international trade, government concessional loans and preferential buyer's credit, the EIBC has also established a special investment fund to participate actively in the investment of overseas projects. Development capital from the two banks is mainly provided in the form of loans. Recent years have also witnessed the involvement of equity investment in some overseas investment projects with high capital demands, long construction periods and slow return schedules. These projects have both a demonstration effect and positive externality. Thus, they share some common features with public goods and development finance. According to the authors' estimation, China possesses a development capital pool of US$200–300 billion for supporting the 'going global' of enterprises, international cooperation of production capacity and projects in the Belt and Road regions.

Considering the characteristics and costs of various funds (see Table 7-4), we may conclude that development funds will become the main support for overseas investment in the priority projects of developing countries. Meanwhile, from the perspectives of market development and project life cycle, the functions of policy-based, development and commercial funds in relation to each other can be described as 'incubation—laying the groundwork—follow-up'. Together, these form a sustainable framework of investment and financing.

Table 7-4: Estimation of cost of external funding for 'go global' enterprises

Policy-based funds	
Financial subsidies, soft loans, etc.	The cost of capital is negligible since profit maximisation is not the goal.
Government concessional loans and preferential buyer's credit	The annual interest rate is around 2–3%.
Development funds	
CDB and EIBC loans	The annual interest rate of export credit is about 4–5%. The annual interest rate of an overseas loan is about 6–7%.
Various equity-based funds	In the case of equity investment, the cost of capital equals its return on equity.
Commercial funds	
Medium- and long-term export credit of commercial banks	The annual interest rate is usually above 7%.
Medium- and long-term loans of commercial banks	The annual interest rate is usually above 7%.

Source: Authors' original calculations based on data extracted in early 2017 from open sources.

For important overseas investment projects eligible for government policy support, different types of funds can be introduced and play a complementary role in providing financial support at different stages of a project's life cycle. Given their low capital cost and indifference to profit, policy-based funds could engage in unprofitable yet indispensable projects that have significant positive externalities and provide fiscal and interest subsidies. Nevertheless, excess fiscal burden should be avoided. Meanwhile, development funds can assist projects at low-profit stages. They can provide capital support at a low cost, help the project grow and subsequently partake in the growth dividends. Commercial funds can become involved when projects are mature and generating steady returns. At this stage, projects would already have been running for some time, accumulating a certain level of credibility. Therefore, should they seek market financing, the cost of capital will be much lower than it would have been at the beginning stage.

For instance, infrastructure projects require a large amount of capital. They are also characterised by long cycles and slow payback timelines. Development financial institutions can enter at the beginning stages, bringing investment from the private sector. Through their unique advantage in connecting government and markets, integrating various resources, providing long-term credit support to those with special needs, and playing a demonstration role for commercial finance, development finance institutions can achieve reasonable returns and sustainability.

Policy finance: Improve the export credit system and provide investment and financing support for Chinese enterprises 'going global'

The export credit system is an important facilitator in the 'going global' of China's products, services, technology and labour. It is also a vital component of China's overseas investment and financing cooperation. Strictly speaking, to date, there has been no widely accepted international rules for export credit. France, Italy, Spain and the UK founded the Berne Union in 1934, which marked the beginning of international export credit coordination.[7] In the 1970s, major developed countries began competing fiercely for export orders from developing countries as their demand for

7 The Berne Union, also known as the International Union of Credit and Investment Insurers, was named after the location of its headquarters in Bern, Switzerland.

capital goods grew. The chaotic situation and ever-increasing export credit subsidies led to the emergence of a so-called 'gentlemen's agreement'. To coordinate export credit policies among developed countries, the Organisation for Economic Co-operation and Development (OECD) developed the 'Arrangement on Officially Supported Export Credits' (the 'gentlemen's agreement') after rounds of negotiations. However, this is only an agreement among developed countries. It does not have the status of international covenants, nor is it legally binding as is international law.

The 'gentlemen's agreement' has undergone constant revision since its promulgation. The Wallen Package adopted in 1987 was an important step in the process of phasing out interest rate subsidies. The package stipulated that the lowest interest rate of export credit provided to high-income countries would not be set below the relevant commercial interest reference rate (CIRR). It also set a minimum quantitative requirement for the concessional level of aid credits. The Helsinki Package, introduced in 1991, was another important revision; it prohibited tied aid for wealthier developing countries and for projects that could be financed commercially. It also ended the bundling of export credit with the procurement of a country's goods and services, clarified that loans from donor governments and their financial institutions should not favour domestic firms and products, and stated that procurement should be conducted by means of open and competitive bidding (OECD, 2011).

In the past, developed countries were the main providers of export credit. However, in recent years, China's export credit has flourished and has taken over some of the market share previously occupied by the US and European countries. This has led to some controversy. The global proportion of China's officially supported export credit rose from 2 per cent in 2001 to 36 per cent in 2014, while that of the G7 declined from 91 per cent to 32 per cent. Instead of following the 'gentlemen's agreement', which distinguishes strictly between concessional and non-concessional loans, China has adopted a more flexible policy that allows for a mix and match between the two types of loans. Generally speaking, the terms and conditions of China's export credits are more favourable than those stipulated in the 'gentlemen's agreement', but less favourable than with aid loans. This has created considerable controversy. Since 2010, the US and European Union have frequently mentioned the international rules of export credit to China, accusing the latter of being too flexible with its export credit schemes and of not abiding by existing international standards. Under such circumstances, the clash between different export credit models has become increasingly acute.

Based on the commercial viability of projects, the 'gentlemen's agreement' divides export credits into two groups: general officially supported export credits and tied aid. For the former, the core principle is 'not too favourable'. In terms of interest rates, the CIRR (the benchmark interest rate of each country plus 100 basis points) has been adopted as the minimum interest rate of fixed rate loans. Specifically, for countries with low levels of interest rate liberalisation, the CIRRs are determined by external standards under the WTO framework.

Regarding repayment terms, the 'gentlemen's agreement' classifies countries into two categories according to their per capita income as estimated by the World Bank. For credit provided by high-income OECD countries, the term is five years, and this can be prolonged to 8.5 years after prior notification. For credit provided by all other countries, the maximum repayment term is 10 years.

Tied aid aims to provide support for countries or projects with little or no access to market financing. To minimise trade distortion, 'the gentlemen's agreement' sets strict rules about the eligibility of countries and projects and the minimum levels of concessionality. The underlying principle is 'favourable enough'. In terms of eligibility, only countries with lower-middle incomes or low-income levels qualify for tied aid. Meanwhile, commercially viable projects, whether public or private, are ineligible. In terms of concessionality levels, the minimum level for tied aid is set at no less than 35 per cent, and no less than 50 per cent for the 'least developed countries' (OECD, 2015).

In general, instead of classifying export credits according to a project's commercial viability, China applies export credit schemes based on the project's specific needs, often using a blend of concessional and non-concessional loans. Subsequently, China's non-concessional export credits are more favourable and its concessional export credits less favourable than those established in the 'gentlemen's agreement'. If China conforms to the agreement's rules, the rapid development of export credit will be affected.

The 'gentlemen's agreement' is not an international custom and it certainly does not reflect the new international pattern of export credit. First, the basic goal of the agreement was to coordinate competition among developed countries in ex-colonial regions and break free of the constraints imposed by the notion of colonial territories. This goal lacks universality. Second, the agreement mainly targets the regulation of export credits from developed to developing countries; hence, the derivation of the phrase 'aid loan'. However, investment and financing cooperation between China and developing countries falls within the scope of 'South-South Cooperation', which stresses the mutually beneficial nature of the relationship. This is completely different from the original goal of the 'gentlemen's agreement'. Finally, the division of export credits based on a project's commercial viability is oversimplified. It fails to capture the diverse financing needs of developing countries. Therefore, China should propel reforms and improve international rules around export credit to provide investment and financing support for the export of its equipment, products and services.

China should also make full use of the communication platforms at various levels to create synergy for the establishment of new international rules on export credit. Specifically, China should make more emerging economies aware of the drawbacks of the 'gentlemen's agreement' and build a consensus through multilevel communication channels. This will improve coherence and coordination in the country's dialogue with developed countries. Internally, China should also promote domestic reform of its export credit system, adjust the procedures of government concessional loans and preferential export buyer's credit, and establish and improve the relevant management systems. In the meantime, to ease controversy, China could raise the concessionality level of its concessional loans by lowering the interest rate and extending the credit period. Further, measures should be taken to clarify the risk profile of commercial export credit vis-à-vis policy-based export credit to ensure capital recovery.

Commercial finance: Improve the overseas network of Chinese financial institutions and services

In recent years, the overseas activities of Chinese enterprises have taken diverse forms, such as cross-border M&As and equity swaps and establishment of overseas factories, research and development centres and industrial parks. This calls for more varied services from financial institutions. Apart from the traditional financial services, including financing, payment, settlement and bank guarantee, an increasing need exists for investment banking services such as M&A, equity investment, derivative transactions, investment consulting, account management, export credit and overseas investment insurance.

Financial institutions should establish a network to share risks and benefits through alignment of financial services, connection of capital markets and financial infrastructures, and communication and collaboration of financial supervisory authorities. (Zhou, 2017). First, Chinese financial institutions should actively develop overseas operation networks. Financial institutions, with their overseas branches at the forefront, play a major role in facilitating financial interconnection. Currently, many developing and emerging economies rely heavily on financial institutions from developed countries for financial services. China's financial institutions must develop and optimise their overseas operation networks, improve professional competence, expand the range of services they provide and initiate financial innovations to serve the needs of Chinese enterprises more effectively. They should provide effective service in investment and financing, financial consulting, insurance and risk management to help enterprises 'go global'.

In the past decade, the global strategy of major international banks has undergone profound changes. Before the 2008 global financial crisis, these banks were in a race to open branches or gain market share through M&As outside their home countries, creating a highly globalised business network in the process. For example, the networks of HSBC, Citibank and Deutsche Bank are spread over 100 countries globally. More than half, perhaps even 70–80 per cent, of the revenue from a few major international banks came from foreign markets. However, in the wake of the 2008 global financial crisis, they made a major adjustment to their global strategy. To deal with the aftershock of the crisis, international banks scaled down foreign operations and shifted the focus—especially the focus of retail business—back to more familiar home markets. This contraction in the global business indicates a relative decline in the capital strength of these banks. This provides great opportunities for China's financial institutions to develop their overseas operation network and achieve internationalisation.

In terms of geographical distribution, the branch offices of Chinese banks are concentrated mainly in Southeast Asian and West Asian countries. Their presence in Central Asian and Commonwealth of Independent States countries is less visible and lags far behind their major international competitors such as HSBC, Citibank and Standard Chartered. According to the authors' survey, the 15 major Chinese banks (ICBC, Agricultural Bank of China, China Construction Bank, BOC, Bank of Communications, CDB, EIBC, China Minsheng Bank, Shanghai Pudong

Development Bank [SPDB], Guangdong Development Bank [now China Guangfa Bank], China Merchants Bank, China Everbright Bank, Ping An Bank, CITIC Bank and China Industrial Bank) have established 220 overseas branches in over 50 countries and regions. Of these, 180 branches belong to the top five banks (49 to the ICBC and 56 to the BOC). Most banks have plans for further expansion, which will lead to an additional 39 overseas branches in total (SPDB, the most ambitious, is preparing to open seven). These branches will be located mainly in Asia and Europe. Specifically, 16 will be in Asia (including Hong Kong Special Administrative Region, Macau Special Administrative Region and Taiwan), 13 in Europe, five in America, three in Africa and two in Oceania. Institutions like the CDB also plan to upgrade their country working groups into representative offices.

In addition to accelerating the overseas network expansion of Chinese financial institutions, emphasis should be placed on expanding the width and depth of their cross-border business and improving services. For instance, China should promote the exploration of cost-sharing mechanisms between banks and enterprises, encourage Chinese banks to provide preferential terms to major overseas projects and receive dividends when the projects begin to make profit. It should also improve hedging tools against currency exchange risk in long-term investments and lower the requirements for sovereign guarantees of project financing in host countries to an appropriate level. China can also relax the full collateral coverage requirement for financing guarantees to reduce the liquidity pressure on 'going global' enterprises.

Correspondent banking is an important component of the international payment system. Through correspondent banking services, the respondent bank can access overseas financial systems for products and services that may not be available in the bank's own jurisdictions. Unfortunately, recent years have witnessed a decline in global correspondent banking business. While increased compliance costs due to tightened supervision is one reason behind this, the downsizing of financial institutions of developed countries also appears to be behind the decision of major transnational banks to reduce or terminate correspondent relationships. Their withdrawals have raised international concerns over potential financial exclusion in developing countries (Bank for International Settlements & World Bank, 2015).

China should deal with the decline of correspondent banking from the aspect of both respondent and correspondent banks. Large correspondent banks are more likely to withdraw from countries with weak supervision, especially of anti-money laundering and counter-terrorist financing. Therefore, those countries should strengthen their supervision capacity building. More importantly, the following measures can be taken. First, differentiated requirements for anti-money laundering and counter-terrorism should be applied to prevent financial exclusion that could be caused by one-size-fits-all rules. Second, the regulators should adopt a pragmatic approach, consult fully with the private sector and key stakeholders in the process of policy design (especially guidelines and procedures) and observe the effects of policy through multiphase deployment. Third, information exchanges between financial institutions should be reinforced to reduce asymmetry and, thereby, improve supervisory effectiveness. Finally, information transparency in cross-border capital flow should be improved.

Additionally, syndicated loans could play a more substantial role in meeting the financing needs of large enterprises and projects and diversifying risks. Syndicated lending is one of the most important forms of financing on the international financial market. It enables the sharing of risk and benefits among financial institutions. In the case of contract breach, lenders can come together to exert pressure on the borrower or determine appropriate solutions. According to statistics from Thomson Reuters, many major international projects and M&As are financed by syndicated loans. In 2014, global syndicated loans totalled US$4.7 trillion. With the rapid globalisation of Chinese enterprises, Chinese banks are becoming increasingly active in international syndicated lending. The BOC and ICBC are among the top 10 lending banks in Asia and the Pacific region. Nevertheless, international syndicated loan business is still at a developing stage in China and Chinese banks do not have an adequate sense of risk diversification. Further, China has yet to establish a standardised secondary platform for syndicated loan transfers. Channels of distribution, buy-back and securitisation remain underdeveloped (Rong, 2017).

China could take the following steps to make full use of syndicated loans in overseas investment and financing cooperation. First, more financial institutions should be engaged. Banks from developed countries with mature mechanisms can help share the capital burden and diversify risks. Financial institutions in host countries could help mitigate commercial and political risks. Domestic financial institutions could partner with each other to avoid disorderly competition. Second, China should promote securitisation of syndicated loans to increase secondary market liquidity, free up more funds, increase the rate of return, and diversify and transfer credit risks in time. Finally, priority of claims in bankruptcy liquidations should be properly designed to reduce the risks.

It is worth mentioning that the financial supervisory authorities should seize the momentum of financial institutions' overseas expansion and encourage them to facilitate 'going global' enterprises. First, the authorities should support expansion of financial institutions based on their functional expertise to achieve differentiated competition and create synergy for supporting the 'going global' of enterprises and the Belt and Road Initiative. Second, the authorities should raise awareness among Chinese financial institutions about risk factors such as the host country's political and economic stability, degree of openness in the local financial market, legal and regulatory provisions, financial supervision, market size, client resources and credit environment. In this way, they will conduct proper due diligence and feasibility studies prior to making any commitment, avoid unnecessary risks, make wise decisions regarding the location of overseas units and ensure sustainable operation. Third, to fully mobilise resources through various channels, China should propel cooperation between Chinese financial institutions and their foreign peers, further open its domestic financial market and grant qualified foreign financial institutions permission to open branches in China. Fourth, China should strengthen communication and coordination between domestic and foreign financial supervisory bodies. A global tightening of supervisory standards in recent years, due to the implementation of various domestic and international programs, suggests that, for Chinese financial institutions, the likelihood to trigger regulatory action overseas is now higher than ever. Therefore, coordination between regulatory bodies is vital. It is also needed to clear regulatory obstacles hindering the overseas expansion of Chinese financial institutions.

Host countries, multilateral development banks, capital markets of developed economies and international financial centres should play their role in overseas investment and financing cooperation

Domestic funds available for overseas investment and financing cooperation are limited. A sizable amount of capital can be gained on the international market. Thus, China should make full use of various kinds of capital. The first of these is the host country's financial resources. According to the World Bank, up until 2014, the gross savings of countries participating in the Belt and Road Initiative amounted to US$9 trillion. Credit loans in 70 per cent of the countries accounted for more than 40 per cent of their GDP. The Sino-Central and Eastern European Financial Holdings Company Limited is a typical example of mobilising the host country's financial resources (see Box 7-2).

Box 7-2: Sino-Central and Eastern European Financial Holding Company

On 24 November 2015, during the Fourth Summit of China and Central and Eastern European Countries, China proposed the establishment of a Sino-Central and Eastern European Financial Holding Company to support production capacity cooperation among member states. The holding company, which comprised China and all Central and Eastern European member states, was officially inaugurated in Latvia on 15 November 2016.

The holding company is an addition to the existing group of international multilateral financial institutions. Established by an intergovernmental agreement between China and Central and Eastern European countries, and operated by member state–authorised financial institutions, the holding company aims to promote production capacity cooperation among the member states through commercialised multilateral financial cooperation. The company adopted a two-tier structure. At the upper tier is the policy-oriented holding company funded by government-authorised institutions. At the lower tier, multiple subplatforms of private equity, investment banking, leasing, insurance and other elements run on commercial principles.

The company enjoys the advantage of super-sovereign credits and the consequent reduced cost of financing. It can achieve an amplifying effect on government funds, using them as seed money to attract and channel social capital and capital from other sources through its commercial subplatforms. Meanwhile, the company will adopt corporate governance practices and commercial approaches. All member countries are shareholders. Together they participate in rulemaking and project selection based on commercial principles. The ICBC, CDB and EIBC were involved in the establishment of the holding company on behalf of China.

China should also draw support from the expertise and capital of multilateral development banks such as the World Bank, IDB Bank, ADB, European Bank for Reconstruction and Development (EBRD), Asian Infrastructure Investment Bank and New Development Bank to promote successful implementation of cross-border projects. To date, China has invested a total of US$7 billion in co-financing programs with multilateral development institutions such as the IDB Bank, ADB and IFC (a member of the World Bank Group), and a further €250 million in the equity participation fund established by the EBRD. Through these co-investment schemes, China can effectively mobilise resources from multilateral development banks and other investors. In addition, given the extensive experience of multilateral development banks in risk management and their influence over and familiarity with host countries, joint investment with these institutions can help mitigate risks.

China's financing model using public funds to leverage multisource capital has been emulated by some major international institutions. For instance, with the European Commission's Fund for Strategic Investments providing first-loss protection, the Investment Plan (the so-called 'Juncker Plan') intends to trigger €315-billion worth of public and private investment. Similarly, World Bank Group programs such as the Managed Co-Lending Portfolio Program and Green Cornerstone Bond Fund provide first-loss coverage with public funds, thereby improving project risk ratings and enticing capital injections from institutional investors such as insurance companies, pension funds and sovereign wealth funds. At the 2016 G20 Hangzhou Summit, multilateral development banks issued a joint declaration. They confirmed their commitment to support infrastructure investment; ensure the high quality and sustainability of projects; explore multipartite cooperation financing models; catalyse private financing; and address the risk elements facing private investors through risk guarantees, credit enhancements and increasing local currency financing.

China should make full use of international capital such as sovereign wealth funds and the capital market of developed economies. According to the World Bank, globally, US$8.55 trillion are placed in negative-yielding bonds, US$24.5 trillion in low-yielding government bonds with a rate of return below 1 per cent, and a further US$8 trillion lies in cash. In other words, for the aforementioned three kinds of funds, over US$40 trillion is unused—this is a potential source of capital for higher yield investments in developing and emerging countries, if investmentgrade assets are available. This measure could also provide China with risk management professionals and tools on the international financial market for its overseas investment and financing cooperation.

Finally, international financial centres such as Hong Kong and London should play to their advantages. Some regional and international financial centres (London, New York, Frankfurt and Singapore) are important platforms for international investment and financing. They have mature capital markets and a large number of institutional investors. Further, their connections to institutional investors worldwide would allow China to attract international capital and investors. China can enter cooperation agreements with financial centres with clearly defined capital contribution obligations. In this way, they can use Chinese funds to mobilise international capital, playing to the natural advantages of these financial hubs. In addition, China could turn overseas projects, including infrastructure projects, into financial products and investment opportunities and access global institutional investors through international financial centres to raise funds for these projects.

Taking Hong Kong as an example, in response to the urgent capital needs for infrastructure development in the Belt and Road countries, the Hong Kong Monetary Authority established the Infrastructure Financing Facilitation Office (IFFO) in July 2016 as a one-stop platform for facilitating infrastructure investments and financing. IFFO is running smoothly at present. Over 60 institutions, including financial institutions, banks, pension funds, sovereign wealth funds and insurance companies, have joined as partners. Among these are the IFC, MIGA, ADB, EIBC, China-Africa Development Fund and Blackstone. Taking London as another example, the city boasts an abundance of innovative financial instruments such as investment guarantee funds and underpinnings and could provide Chinese enterprises with services not available elsewhere. Indeed, London is host to China's first green asset–backed security, which went public in 2016.

Meanwhile, the clustering of major financial institutions and professional services firms in international financial centres creates extensive connections and world-leading expertise in areas such as trade finance, marine finance, insurance, financial operation and risk management. This can be used to China's benefit, to prevent various risks associated with finance, environment, regulation and markets. Major financial centres are also important RMB trading centres and offshore RMB markets, offering abundant RMB-related financial products. With the RMB's increased use in investment and financing, these centres can provide easily accessed RMB services to investors worldwide.

Use multiple investment and financing models and make full use of equity investment

China should use all types of investments and financing tools, especially equity investment. Overseas investments create financial needs for infrastructure financing, trade financing, risk management in cross-border transactions, cross-border trade settlements and financial infrastructure. Therefore, a diverse set of financial instruments is needed, each playing to its own advantage and together creating synergy.

Meanwhile, a high demand exists for equity investment among enterprises investing overseas. Equity investment can serve as high-powered funds in overseas investment and financing cooperation. Generally speaking, equity investment can enhance the capital strength of projects and investing firms and leverage debt financing, such as loans. Moreover, equity investment can also provide greater control over investment and project operations. To tackle problems faced by many host countries of Chinese investment, such as high leverage ratios and limited access to foreign credit, the proportion of equity investment should be increased and various models such as direct, entrusted and joint investment should be used to make full use of equity funds and private equity investment. In this way, risks can be diversified, and the sustainable development of investment and financing achieved.

Simultaneously, equity funds can help enterprises mobilise Chinese resources, by combining direct investment with policy agendas such as economic structural adjustment, the 'going global' of technical standards, cooperation in equipment manufacturing and RMB internationalisation, to reap long-term rewards and improve the overall efficacy of overseas investment and financing projects. However, it is worth mentioning that despite the advantages listed above, the risks and uncertainties associated with equity investment are higher compared to other types of financing, such as loans. Therefore, proper measures should be established to control relevant risks.

In conclusion, first, China should give full play to equity investment funds such as the Silk Road Fund, China-Africa Industrial Production Capacity Cooperation Fund, China-Latin America Industrial Production Capacity Cooperation Fund and overseas RMB funds. This will increase the proportion of equity investment; absorb capital, technology and experience from relevant countries; and enhance the overall benefit of projects. Second, allocation of resources should be made more efficient, and the interests of all parties should be maximised, rather than assuming that China is providing aid to economies in need. Third, the government should provide guidance and support for equity investments that produce public goods or have the feature of development finance projects. This will ensure their sustainability.

China should also pay special attention to the international coordination of rules regarding equity investment and actively participate in the making and improvement of these rules. For instance, at present, multilateral developmental institutions such as the World Bank have a co-investment policy that asserts co-investment is reserved only for the private sector, not for government-funded institutions. Such policies do not accord with the international community's principle of mobilising all types of resources for project construction, nor do they meet the actual needs of developing countries and emerging economies. Therefore, it is necessary to bring multilateral development institutions on board in terms of improving existing rules to foster win–win cooperation. Meanwhile, from the perspective of investment sustainability, China can play an active role in forming international rules in new and emerging areas such as environmental risk management and green finance. For instance, China has the largest green finance market. Many countries and international organisations have a strong intention to cooperate with China in establishing global green finance standards. A leadership role in the development of such standards could help promote China's image among people in host countries and ensure the smooth and sustainable operation of investment projects.

Equity investment institutions have made useful attempts to connect capital and industry, improve market openness and promote the complementarity of production factors. The Silk Road Fund is a medium- to long-term development investment institution established to support the Belt and Road Initiative. As of May 2017, the fund had signed 15 projects and pledged a total of US$6 billion in investment in Russia, Mongolia, Central Asia, South Asia, Southeast Asia, West Asia, North

Africa and Europe. The projects cover infrastructure development, resource exploitation, industrial production and financial cooperation. The fund has also committed another US$2 billion to set up a sub-fund for China–Kazakhstan industrial production capacity cooperation. So far, equity investment accounts for more than 70 per cent of the total investment of the Silk Road Fund. Apart from equity funds, the fund also combines several investment vehicles such as credits, loans and funds to meet differentiated financing demands. Meanwhile, the fund places much emphasis on serving China's benefits in investment decision-making. It plays an active role in promoting the engagement of Chinese enterprises in international production capacity cooperation, the 'going global' of China's equipment manufacturing industry and the importation of advanced technologies.

Additionally, the overseas RMB fund established in 2017 is likely to play a vital role. The fund positions itself as a medium- to long-term financing platform with businesses ranging from overseas RMB loans and equity investments to cross-border guarantees. Overseas loan services consist of overseas project financing, acquisition loans and short-term bridge loans. Equity investment and cross-border guarantee services are mainly provided for overseas projects and participating enterprises. It is estimated that a substantial proportion of RMB received by the fund's client countries will be used for importing goods and services from China, thereby creating a virtuous cycle that serves the real economy in which the RMB recycles through a 'capital outflow and trade inflow' mechanism.

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